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CORPORATE PARTICIPANTS

Kelly Hsu *HTC Corporation - IR Manager*

Chialin Chang *HTC Corporation - President Smartphone & Connected Devices*

Peter Shen *HTC Corporation - CFO*

CONFERENCE CALL PARTICIPANTS

Richard Kramer *Arete Research - Analyst*

Wei Chen *Goldman Sachs - Analyst*

Skye Chen *CLSA - Analyst*

Julie Tai *UBS - Analyst*

Kylie Huang *Daiwa - Analyst*

PRESENTATION

Operator

Welcome everyone to HTC's 2016 second quarter results conference call webcast in English. Today, with us, we have President of Smartphone and Connected Device business, Mr. Chialin Chang, CFO, Mr. Peter Shen, and Investor Relations Ms. Kelly Hsu. (Operator Instructions). And for your information, this conference call is now being broadcasted live over the internet. Webcast replay and English transcript will be available within an hour after the conference call is finished. And Chinese translated transcript will be available within a week after the call is finished. Please visit www.htc.com under the Investors section.

Now I would like to introduce Ms. Kelly Hsu from Investor Relations. Ms. Hsu you may begin.

Kelly Hsu - HTC Corporation - IR Manager

Thank you. Good morning, good afternoon and good evening ladies and gentlemen. Welcome to HTC's 2016 second quarter earnings call. This is Kelly Hsu, HTC's IR Manager. The event is now being webcast live via HTC's website at www.htc.com. If you are joining us with the dial-in line, your call is now being placed on mute. As this conference is being broadcast by investors around the world, we will conduct the call in English only.

The format for today's call will be as follows. First I will summarize our operations for the second quarter. Afterwards our President of Smartphone and Connected Devices, Mr. Chialin Chang and CFO Mr. Peter Shen will lead the Q&A session.

Before we begin, I would like to draw your attention to the disclaimer statement on page 2 of the slide. Please note that this presentation contains forward-looking statements. These statements are based on our current expectations. Actual results may differ materially from our expectations. Actual results may differ materially from our expectations and the Company undertakes no obligation to update these forward-looking statements going forward.

If there is no questions, I will begin to give the overview for the second quarter 2016. Please turn to page 3.

Page 3, second quarter financial highlights. Revenue for second quarter was TWD18.9 billion with gross margin of 11.4%. Operating loss was TWD4.2 billion and operating margin of negative 22.5%.

We have recognized a disposal gain of TWD1 billion from sales of land in Taoyuan.



And net loss after tax was TWD3.1 billion, or loss per share of TWD3.71.

Business update. Revenue for second quarter rose 27% quarter-on-quarter, boosted by HTC 10 and HTC Vive. We anticipate sales momentum of the HTC 10 to continue into second half.

HTC continues to build a robust VR ecosystem through regional and channel expansion, as well as collaboration with developers to create contents in diverse categories and verticals.

Page 4. Page 4 gives you an overview on revenue and operating profit. Revenue for second quarter was TWD18.9 billion and operating loss was TWD4.2 billion.

Page 5. Page 5 gives an overview on gross margin and operating margin. Gross margin for second quarter was 11.4% and operating margin was negative 22.5%.

Page 6 and 7 are financial overview for income statements and balance sheet.

This wraps up the content of our presentation. And now I would like to turn the podium to the President of Smartphone and Connected Device business, Mr. Chialin Chang and CFO Peter Shen.

Moderator, we can start the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Richard Kramer, Arete Research.

Richard Kramer - Arete Research - Analyst

Hi guys. A couple of questions, please. First one, near term, when you say the sales momentum will continue in the second half, are you anticipating that you will grow year-on-year in the third quarter, when you start to have (inaudible).

And then the second question, can you clarify, among the results, what portion is own-brand HTC sales? And what portion would be brand licensing that you're doing for -- to other ODMs for example, the Desire series products, and how that would break down in the P&L?

And then I have a third bigger picture question, but maybe we'll take these two first please. Thanks.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Thank you Richard, this is Chialin. Hi everyone. First of all, before I answer your question, I would like to take this opportunity to introduce Peter. Peter Shen just got on board last month as the CFO. Peter basically has extensive experience in the finance/accounting, in the CFO capacity, both in the US, in Taiwan. He also spent quite a few years in China as well, [with offers] dealing also in terms of potential strategic transaction (inaudible). So we welcome Peter on board. He's here with us today.

Peter Shen - HTC Corporation - CFO

Thank you Chialin.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Coming to your question, Richard, I would say we expect Q3 we have a sequential momentum on both the smartphones and the continued momentum on the Vive side.

So we believe in Q3 our financial performance, both on the top line and bottom line, will be improved from the second quarter. And given that we're in the transition phase, in terms of improving our entire organization, our cost structure and streamlining our business in there, [we'll compare] to a quarter over quarter. So that's our comment.

Operator

Sorry, Mr. Kramer, do you have more questions for our speakers today?

Richard Kramer - Arete Research - Analyst

(Technical difficulty).

Operator

Sorry Mr. Kramer, we can't hear you. Go ahead please.

Richard Kramer - Arete Research - Analyst

(Technical difficulty) for Peter, for the new CFO. How important is it for HTC to turn profitable in -- either in the end of this year or even in next year, because it seems very difficult to make money at that gross margin level. And can you give us a sense of programs that you have under way that might bring that lower margin up so that you have more scope to revert the negative 22% of operating margin? Thank you.

Peter Shen - HTC Corporation - CFO

Thanks Richard; this is Peter. So I hate to give you the same answer, but we do not give guidance, right. So I'm not going to speculate and discuss and provide color on whether we think -- how important is it to break even in the near future and the prospects of that.

I think one of our comments I'd emphasize on is I feel like we have a pretty strong and pretty solid plan to get us to a reasonable cost structure and the appropriate margins to get us to a breakeven level. [As planned], Chialin's been [leading], and I think that we have a reasonable chance of this; really hitting that goal.

And obviously, you'll be all aware, we are making -- we have started to and making significant progress. And over the last month and a half -- month to two months, on the VR front. And obviously that's a big initiative for us as well. And this -- we're going to be in investment phase going forward for a bit. So that's our comment. Okay, thanks.

Richard Kramer - Arete Research - Analyst

Okay. But just to be clear then, are you assuming that getting back to a profitability was about reducing the cost structure or is it more relying on resuming revenue growth in the core smartphone business, because I think we all know that VR, for the moment, remains relatively small.

Peter Shen - HTC Corporation - CFO

Well, we all know for any healthy company, right, you cannot really make a profit through continuous cost cutting. We do need scale, we do need a healthy business on the volume side. So I would say we've done a lot of good work to get to right size our cost structure and we're really there, I think. So obviously I think -- we definitely may have more room to look at, but as a Company -- as any good company, I guess cost-conscious company, that we need to be always on the watch for that.

But I think for us, right now, going forward, we obviously need to scale back and get -- and right-size our cost structure along with that. So --

Richard Kramer - Arete Research - Analyst

Okay. And maybe one last one for Chialin. Clearly there were some inventory issues at the back end of last year and early this year. Are you confident you've cleared all the inventory in the channel right now, or is that something that we could still expect to see as a drag in the coming quarter or two?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

In terms of channel inventories, after the sales of goods, the selling of goods, I think the channel inventory has been healthy. The flagship channel inventory we just launched is also very healthy.

Richard Kramer - Arete Research - Analyst

Okay. Thanks guys.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Thanks.

Opera

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Thanks.

Operator

Wei Chen, Goldman Sachs.

Wei Chen - Goldman Sachs - Analyst

Hi guys. So my first question is for Chialin. So can you comment -- actually it's around gross margin. So we see sales improving 27% sequentially, but in terms of gross margin we see a marginal improvement, from 9% to slightly over 11%. So can you first comment about the gross margin dynamic, given that HTC 10 has launched which is a new product cycle. So I think the street was expecting a pretty meaningful gross margin recovery. Can you tell us how it has got to 11% during the quarter? Thank you, that's the first one.



Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Thank you. I can comment to you the gross margin of our flagship product would be materially higher than the average gross margin [you've got there]. Obviously, at the end of the day, anything on gross margin would be the entire mixture of the product mix, so that would be a result of it. But specifically on a gross margin, it would be materially higher than this.

Wei Chen - Goldman Sachs - Analyst

Right. So we do we see the mix improving going to 3Q?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I think -- we hope -- I would say the following. Just take this opportunity to add we hope we will continue to ship the same number. I won't be able to disclose to you exactly the number, but that it will continue to ship. We expect to ship the similar level of flagship volume. Obviously our internal hope is actually it will be higher and that we'd be improving on it. But overall the gross margin will be the whole, the entire combination of product mix in there. It depends on the competition environment. I can see the smartphone side is pretty competitive. There's a lot of mixture in that and that will result in a mix, gross margin change.

Wei Chen - Goldman Sachs - Analyst

Understand. And one of the positives during the quarter was OpEx; it was very well managed. So it was basically close to flat sequentially, given higher sales. So can you talk about how the cost saving is coming through and do you see the OpEx, on an absolute dollar basis, continuing to go down into 3Q, or this is the bottom of the OpEx savings or are we going to continue that process?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I think basically -- first of all, we'll continue to optimize our operating expenses. After the third quarter number when we report it back, hopefully we'll have more color and granularity we can report back.

Currently we expect, going forward into the third quarter here we're hoping to maintain similar levels; if we're not lower than that will be something -- similar, a similar level. We can't be sure, for certain, because certain spending here is a variable. But we try to maintain a certain level we think is healthy, without hurting the fabric of the Company, so we can continue to position ourselves for future growth.

So we watch that pretty carefully. But, like Peter said, you can only optimize so much on the cost structure side, that [you're seen to be maintaining] your core competency. At the end of the day you also need to drive revenues and gross profit.

Wei Chen - Goldman Sachs - Analyst

Yes, understand. So net-net I remember last quarter results, Chialin commented about smartphone potential breakeven to 3Q. Do you see that being on track?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Yes. I mentioned basically in the last conference call that we hoped we would be able to break even on the smartphone business. I think we continue to maintain that hope. Obviously there's still two months to go; there's a lot of uncertainty, given the even hyper-intensified competition in that. So we'll continue to be vigilant, but that's still our hope for third quarter, on the smartphone side



Wei Chen - *Goldman Sachs - Analyst*

Got it. Last question is for Peter. So I think investors are really looking at HTC as a virtual reality company. We seeing the smartphone business undergoing restructuring and that's the transformation. But currently smartphone continues to burn a lot of cash every quarter, while Vive is contributing, but it will still take some time. So how do you balance out this transition from a financial perspective?

Peter Shen - *HTC Corporation - CFO*

I think, as Chialin says, right, so near-term target, we need to get the -- with all the work on the right-sizing our cost structure on the smartphone side, we've got to get some of our scale back. And hopefully that will get to a neutral to positive cash flow position on the smartphone business side.

Wei Chen - *Goldman Sachs - Analyst*

Okay. And thanks. And I guess just a last one; can you talk about -- briefly about how Vive is -- because it just [went on] around [retail stores]. Can you talk about the feedback for the Vive product in retail? And that's my last question; thank you gentlemen.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

The feedback was very good. We had a great momentum, so we like where it's going. So we hope it will continue that momentum. Beyond that, we won't be able to disclose too much, but the feedback is very strong from people who have experienced it. For those who are on the call who have not experienced it, please contact us. We would love to give you the experience -- you would know the difference in this (inaudible), so we love where we're positioned.

Wei Chen - *Goldman Sachs - Analyst*

Got it; thank you.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

Thank you.

Operator

Skye Chen, CLSA.

Skye Chen - *CLSA - Analyst*

Hi gentlemen, this is Skye. I just had two follow-up question. Do we expect the Vive shipment will continue to grow quarter-on-quarter in the third quarter? That's my first question; sorry.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

I think we started out shipping, I don't recall exactly, sometime in April there. So we continue to get that momentum, yes.

Skye Chen - CLSA - Analyst

Okay. And also can you give us an idea, does the Vive now have a positive impact or negative impact on your operating margin?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I would say the following; because we're not providing guidance any more. And there's a lot of break down on financial disclosures here; we're not giving for competitive reason here. As I said, actually some of you may have heard at the shareholder meeting back in June, when we sell Vive there is a positive contribution in the gross profit and gross margin for HTC.

Skye Chen - CLSA - Analyst

How about operating profit; is it also positive on the operating level?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I can only comment on [what I just said].

Skye Chen - CLSA - Analyst

Okay, thanks.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Thanks.

Operator

Richard Kramer, Arete Research.

Richard Kramer - Arete Research - Analyst

Yes Chialin, just in the previous question about a transition to VR, two specific questions. Do you anticipate, at some stage, breaking out the non-smartphone proportion of sales, just so that investors can see the growth there?

And I guess the second question, with the VR VC fund that you're raising, will that be something that HTC itself is funding, or is that something that's Cher's funding, or is there any participation directly from HTC shareholders in that VR development fund? Thanks.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Okay. Richard, these are all two pretty good questions. So allow us some opportunity to elaborate on it. First of all, we do believe, and we hope at some point when both businesses getting more stable, we're in a position to provide more breakdown and disclosure, without compromising our outside competitiveness, given the sensitive competitive information in that regard.

I do want to emphasize that the -- we're not downplaying smartphones and focused on the VR only. Okay? I do think we do have a great position in the beginning of the VR ecosystem and we want to capitalize on that ecosystem. At the end of the day, you're going to have a mobility, virtual reality, augmented reality, all combined together. So we think with that expertise in multiple areas, it will position us in a good position in the future. That's number one.

Number two, I want to emphasize, as we talk about it also in shareholder meetings, one, we create a 100% HTC-owned company and -- on the VR business. The purpose of doing that is actually two-fold. One, as we said, actually we said it in the shareholder meeting, we want to position HTC well in that ecosystem. We're not just a hardware provider.

And in the future, in the growth of the ecosystem, we need partners; also it's the partnerships that need to be linked. So hopefully through the formation of the entity here, if, in the process of forming a partnership -- it's not necessarily a must, I do need to emphasize -- if it's required, and then there's some sort of minority stake needs to be required, we will consider that. But we're not doing that for the purpose of selling a minority stake; I do need to emphasize that in that regard.

And also to add that point here, if somebody, in the benefit of HTC shareholders, we accept that minority investment there, it would be good for HTC's position in the ecosystem. So it would be a pretty well-known (inaudible) and people all think it makes sense that kind of partnership in that (inaudible). And that would not be Cher Wang. Cher Wang herself is not involved in any of those. So we create an entity here; it's to benefit the shareholders of HTC.

Richard Kramer - *Arete Research - Analyst*

Okay. And just on that ecosystem point, how do you -- how should investors think about you competing with much larger and very deep-pocketed ecosystems, whether it's a Facebook with \$23 billion in cash, working on Oculus, or Google, which has created reference design for VR. Or Sony where, I'd say, obviously they have huge resources in content and technology. And it's probably an existential necessity for them to succeed in VR. How do you think about competing with them and what sort of partners should we be looking for HTC to get on board with in that battle?

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

I think there's a lot of conversations going on; that's the beauty of this competitive world and the technology space in there. Incumbent has a lot of resources; must always have the advantage in there. Different innovations, partnerships, business models will also create new opportunities in there. So it remains to be seen and how this will play out in the next couple of years.

We indeed -- given that the advantage we have creating the Vive, and the unique and powerful experience we can have compared to other competitive products in there, we are able to draw more developers, creating more consumer-friendly [devising] experiences in that regard. And that will continue to grow. And hopefully we'll attract more people who are important to the ecosystem, whether it's the content or other platform company here, and that will position HTC better in the future.

Richard Kramer - *Arete Research - Analyst*

Okay, thanks a lot.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

Thank you.



Operator

(Operator Instructions). Julie Tai, UBS.

Julie Tai - UBS - Analyst

Thank you, operator.

Gentlemen, I just want to ask is it possible to give us a bit of guidance on the split between the smartphone and VR in Q2 in terms of revenue?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

We're not in a position to split yet for all sorts of reasons we just described in there. Hopefully in due time here when both businesses become more stable, it'll be more clear. But gradually that's the direction we're trying to add more exposure to allow our investors to understand better the business, at the same time try to manage the balance in terms of competitive information.

Julie Tai - UBS - Analyst

I see. And perhaps is there a -- maybe a target, maybe by year-end we will be able to know a bit more.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

My target would not be a timetable target. My target would be based on that how stable we think it will be.

Julie Tai - UBS - Analyst

Which is the shipment volume of VR I guess or the technology of VR stabilizing, in your opinion?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

When we say -- when we say the stable business i.e., (inaudible) the stable business becomes more predictable of the business and that will be the product, technology, how your business is going to sustain in a stable way. That's what I meant.

Julie Tai - UBS - Analyst

Thank you.

And my second question is you did -- guided us that the flagship products are a bit higher than the -- margin wise is higher than the corporate average. But could you also identify these flagship products for us and what kind of revenue it is?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I was not able to break down more detail to talk about it. I did comment on it which I can comment again that our flagship gross margin will be materially higher than the overall average gross margin there. I also commented on it we expect probably similar volume and shipment in Q3 on flagship compared to Q2. Our internal view, we're hoping we can higher. But it all depends on the external competition and how we position our flagship.



Julie Tai - UBS - Analyst

Is it fair to guess that when you say flagship product, you meant M10 and also the Vive?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Our flagship smartphones are HTC One M10. Vive is coming out strong and actually the momentum is there and we expect the momentum to continue. Some of you may have heard we started out initially with the purely online only. We selectively are going with the offline retail channel. That would extend the footprint, so that should be a positive direction.

Julie Tai - UBS - Analyst

I see, okay. And in addition to that what kind of progress do you have planned for VR, meaning that which region will be the product focus?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Our VR sales is global. Some of the industrial economies actually the -- hopefully in those markets you have more percentage, a higher percentage so-called early adopters or people who are sophisticated [enough] in there. Some of the major markets you can imagine. I think we have -- for example, we have good traction in the US, we have good traction in China, we have good traction in the UK, Germany, Australia. All these countries, you can think about it.

Indeed, we are not extending into all major countries globally such as some of the emerging markets there. We're taking our time. But our steps as you can see is extended beyond the online channel going to the select retailers in these industrial economies.

Julie Tai - UBS - Analyst

But Chialin, do you think the strategy would be more focused on retail [individual] or more of a commercial usage or collaboration for the VR development?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

What you're saying is, is this is going to B2C or B2B. I think it will be both.

Julie Tai - UBS - Analyst

I see. And how about the smartphone strategy right now because we are hearing a lot of mid to low-end segment are doing quite well. What is your strategy for the smartphone?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I think the smartphone business here is -- it's very clear our flagship needs to work and the flagship as I talked about it also in the shareholder meeting, our flagship did not perform well last year. That created issue for HTC and there is a lingering effect in that. So we're gradually recovering from the bottom in there.

The flagship needs to perform well on the top end in there. Then it hopefully percolates to the premium, mid-tier and the affordable size. We need to do affordable size because in certain markets, due to the partners' requirement, some of the operators require the sort of lower price product. Lower price product in Taiwan means around TWD5000 for example. We do have a position in that and that does not tend to have a higher gross margin, but we need it for strategic in there. But the key is still selling the flagship and then the rest of the portfolio, giving us the right gross profit.

Julie Tai - UBS - Analyst

But I think around the world for top name brands, their flagship model or higher pricing premium model aren't doing that well. That's -- I guess that's the (inaudible) this year's general trend though. But you are still sticking to the strategy of making your premium model to work.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I will answer your question in the following way. It's not clear, if we just use the Taiwan setting because all of -- most of you guys based in Taiwan. You can imagine if a smartphone company is focusing only on products selling at TWD5000, versus the company who has a portfolio selling at TWD10,000, TWD15,000 and above TWD20,000. For the smartphone selling above TWD20,000, the gross profit from each smartphone will be multiple times for the smartphone selling at say, TWD5000 without being explicit to tell you how big is the multiple.

So focusing on the top end and the mid-tier and premium is important given the gross profit there. And I can still tell you the flagship and the premium still accounts for the majority of the gross profit of the smartphone. That's why we say, the focus.

Yes, indeed the affordable size is getting bigger, but the question remains who will actually will benefit, even for the entire smartphone space, who will actually benefit, i.e. reaping a lot of gross profit coming out of selling purely from the low end, based on my sort of as a practitioner's view in this space I think it would be challenging.

Julie Tai - UBS - Analyst

I see. Thank you for sharing with us. Operator, this ends my questions at this point.

Operator

(Operator Instructions). [Val], Turiya Capital.

Unidentified Participant

Hi, this is [Silas] from Turiya Capital.

The first question, are you able to talk about whether more of the growth in revenues on a quarter-on-quarter basis is driven by phones or driven by the Vive?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

First of all, you can imagine when we talk about Q2, the Vive we just start selling it. So quarter-on-quarter, there's no such a thing here in terms of quarter-on-quarter comparison because Q1, we don't have Vive selling in there. I think we'll continue the momentum of Vive selling into Q3 and we believe the -- we believe Q3 the smartphone also will grow on the revenue. So it's our hope that both will continue the growth in terms of Q3 over Q2.

Unidentified Participant

Right. I guess the question I was asking is the Q2 revenue growth over Q1, the TWD18.9 billion over the TWD14.8 billion, that extra TWD4.1 billion, did the Vive drive more of that or did the phones drive more of that?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I would not be able to comment on that off the top of my head. I don't know the specific in there. I think both are driving it.

Unidentified Participant

Okay, great. And I just noticed I think yesterday that HTC re-priced the Vive in the UK. You guys brought the price up by 10%. I thought that was quite interesting because the Oculus Rift have kept their prices the same despite the falling pound. So I was wondering what that means or that implies for the demand out there, how you guys thought about that pricing decision?

It appears to be quite a strong move to do that first and unilaterally to raise prices in what appears to be a weak environment in the UK.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I would not be able to know -- we need to find out what you're referring to, because globally I don't believe we're actually changing the price for Vive. Obviously there is Vive bundled with more stuff selling to enterprise that could be different. And then they're selling in the UK, one of the large retailers there, if there's some bundle opportunity or after sales services all those you have to look at the detail in there. On a standalone basis for the same thing, I don't think we're changing price at all.

Unidentified Participant

Right. Hold on, if you can give me a second. I thought this came from your official blog, the UK customer announcement, due to recent currency devaluation changes, the current value of the HTC Vive is now GBP759. And I think it used to GBP689. This was on your blog.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

That's -- as you know that -- as you know, Peter over here is looking at the stuff, looking into it. [We could just say] because the reflection -- what you said could be right here, so we can confirm on that. But we said price doesn't change based on the US dollar, given the UK currency depreciate (multiple speakers) margin, so it's just reflecting that. So that doesn't mean that we're reducing the price -- well, we're increasing the price globally. It's just because of the currency exchange in that certain market.

Unidentified Participant

Fair enough. If I could squeeze in a last one, we have about 2 points of gross margin improvement in the second quarter. As you say, the first quarter did not contain the Vive. The second quarter contained some amount of the Vive. It just appears that the gross margin of Vive is not materially higher than the previous corporate average which appears a bit surprising to me given the price of the Vive because it's at the price level of a very high-end smartphone. And in terms of the BOM cost, one can debate it, but it doesn't appear the BOM cost should be super, super high and to have only 2 points of increase suggests that the Vive gross margin was quite low. I'm not sure if that's the right interpretation.

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

I will comment in the following way. That's why we don't break down for you exactly the competitive reasons in that because we don't want people to cut into those because there are a lot of factors affecting the entire -- the gross margin of the overall Company. And the reason we don't want to break down here is we don't want people -- the competition to second guess on that and that could hurt our competitive relationships. I wouldn't be able to comment on what you just said here, but I don't think you're getting the whole picture.

Unidentified Participant

Okay. Would I -- would it be fair to say that as you produce the Vive and the product becomes more mature that the gross margin could improve as it would do in a typical product?

Peter Shen - HTC Corporation - CFO

I think that you can imagine basically on a standalone basis, if a product -- the price could be maintained the same and then we'll continue to improve the cost structure, of course the gross margin will be better. But that probably is the new point in that regard because the competition is always there.

But I would just emphasize as I said earlier, Vive does contribute to positive gross margin, but I won't be able to break down what exactly it is for competitive reasons.

Unidentified Participant

Thank you. Appreciate that.

Operator

Kylie Huang, Daiwa.

Kylie Huang - Daiwa - Analyst

Thanks Chialin to take my question. I have two question.

The first question is regarding the third quarter outlook. I apologize that I get in the call a bit late. I just want to clarify, you mentioned in the third quarter you expect the revenue growth momentum to continue. But I was wondering -- I recall last quarter you mentioned for smartphone you target to have breakeven in the third quarter. Is this still our target?

Chialin Chang - HTC Corporation - President Smartphone & Connected Devices

Yes, based on your question I can tell you did indeed get on the call late. First of all, we did say that we expect the third quarter in terms of revenue and bottom line will improve from the second quarter. Second thing, I also said that we still hope that our smartphone business will break even but obviously there's still a lot of uncertainty dealing with consumer electronics, especially the smartphone business with still August and September to go.

Kylie Huang - *Daiwa - Analyst*

Okay, I understand. Thank you very much. The second question is actually regarding Vive. I just [wondered the following], because you mentioned that right now Vive will go into different channel. So does it mean -- indicate the pricing could have some difference? I mean i.e. for other channel you need to share some profit with them, so your FOB -- ASP could be lower and impact your gross margin?

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

As I said here, we have no intention, we will maintain the same price. Maybe what I said, just to be precise, is the same price in US dollars. Certain markets due to exchange rates maybe will reflect a little bit but that price will not change because it's online and offline. We have our way of managing the channels et cetera, which I will not be able to disclose, but we're happy with the way we're going.

Kylie Huang - *Daiwa - Analyst*

Okay. So the share we can expect of Vive, the volumes are still going up but ASP actually won't have a material change and we can still expect the margin expansion. Is that correct?

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

As I said, that I think you are adding a lot of assumption into it. I think we've opened our channel, hopefully we can increase the footprint and the positive momentum will continue.

And then just to comment on the earlier person's comment, for a consumer product, if you can maintain the price the same, then if you can improve the cost structure, of course naturally the gross margin will be better. So that's obviously the assumption of one, we continue to maintain the same ASP; second, you improve the cost structure, so it results in the third, right. So that's a lot of assumptions in there.

Kylie Huang - *Daiwa - Analyst*

So that's not for sure yet, right. So we need to see how the market goes and to see if there are any change in terms of those assumptions.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

Yes.

Kylie Huang - *Daiwa - Analyst*

Okay. Thank you very much.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

Thank you.

Operator

Wei Chen, Goldman Sachs.



Wei Chen - *Goldman Sachs - Analyst*

Hi, sorry. Yes, so I wanted to clarify some numbers. Did you say Vive units are going to be flat sequentially -- sorry to be up sequentially? And then the flagship smartphones units will be flat sequentially, but net-net [3Q] level will be up. Just want to make sure I got the numbers right.

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

Okay, let me repeat what we just said. Peter and I commented on it throughout the call here and hopefully that will bring us to the right ending to the call.

First, we expect Q3 revenue and bottom line improve from Q2. Second, given people asked which I commented on it, but we still hope smartphone business will break even, but still there's uncertainty because of August and September. And third, I commented during the call that we're happy where Vive momentum is going and we expect the momentum will continue into Q3. So there will not be some of the things you commented on, it'll be just what I just said.

Wei Chen - *Goldman Sachs - Analyst*

Okay.

In terms of the scale, the actual smartphone, how do you think the -- what kind of scale do you need to get this breakeven level?

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

I won't be able to tell you that because there's a lot of factors in there and not just the smartphone in that. And what I can tell you is what I comment on it which is a similar volume shipment in Q3 on smartphone versus Q2, internally we hope higher. And that's all I can comment.

Wei Chen - *Goldman Sachs - Analyst*

I see, okay. And lastly for Vive, how do you think about the product replacement cycle? Is there something closer to a smartphone or something closer to a PC or games console? How do you think about that product?

Chialin Chang - *HTC Corporation - President Smartphone & Connected Devices*

I think the Vive, so far we're enjoying the feedback. It doesn't appear to us -- obviously we have I think a pretty good road map plan for our VR business, which I won't be able to comment. But based on my personal observations the -- very few products would have the kind of the short lifecycle like smartphones.

Wei Chen - *Goldman Sachs - Analyst*

Okay. Thank you. That was helpful. That's all, thanks.

Operator

Thank you for all your questions. I'll pass the call back to Ms. Kelly Hsu for closing remarks. Ms. Hsu please proceed.



Kelly Hsu - *HTC Corporation - IR Manager*

Thanks everyone for joining our call today. Bye.

Operator

Thank you, Kelly and we thank you for your participation in HTC's conference. There will be a webcast replay within an hour. Please visit www.htc.com under the investor section. You may disconnect. Goodbye.

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